

# J.M. Hartwell L.P.

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Investment Counsel since 1961

## **Investment Review and Outlook Third Quarter 2011**

Stock markets ended a turbulent quarter on a day where markets fell sharply. The sell off capped a dismal quarter, the S&P 500 was off 13.9%, marked by anxiety about the European sovereign debt crisis, a U.S. economy flirting with a double-dip recession, and signs that hitherto, fast growing economies such as China are slowing down. It was the worst quarter for equity markets since the fourth quarter of 2008.

We are disappointed with our results this year, but feel strongly that the stock market will show positive returns over the next 6 - 12 months and that the companies in your portfolio represent great value. Performance has improved since the end of the quarter.

The reason for the third quarter disappointment was a portfolio positioned for continued global growth. Our large exposure in energy, energy services, and cyclicals was based on a strong fundamental thesis. We were too bullish on global growth. Signs pointing to a benign outlook for U.S. equities included moderate undervaluations, strong corporate free cash flow, Fed policy and improving consumer balance sheets.

We expected a continued moderate recovery in the U.S. with relatively positive macro economic data points. Instead, the economy has exhibited tremendous volatility due to government fiscal and monetary issues. A deterioration in Europe and continued credit tightening in China had a direct negative affect on our energy and cyclical holdings. These holdings declined 25% in the quarter and accounted for the disappointing performance.

We continue to remain optimistic about the outlook for positive stock returns despite the current lack of interest for riskier investments. Investors have moved to the safety of cash and treasuries as witnessed by the decline in the U.S. Treasury yields and the spike in M2 (a broad measure of the amount of money in circulation). The volatility of the equity markets and individual stocks has dismayed many investors. They have withdrawn significant sums from equities mutual funds in July and August. Funds that invest primarily in the U.S. disgorged \$25.6 billion in August, having taken out \$28 billion in July. Taxable bond funds had withdrawals of \$3 billion in August after inflows of \$9 billion in July. Bond funds had inflows of \$73 billion year-to-date versus \$213 billion a year earlier. All this inflow into cash and bond funds seems particularly unusual given the current level of interest rates and common stock valuations.

After periods like this, it is reasonable to ask whether equities offer attractive valuations. Equities in general and growth stocks in particular appear undervalued relative to their historic valuations. The risk premium for equities is now approximately 6% (measured by excess return over TIPS) versus a long-term average of 3%. It is higher than the troughs of the 1991-1992 and 2001-2002 downturns. Another perspective is that a halving in earnings for 2012 is already built into the risk premium. This is extremely unlikely.

Insiders are buying their own stock. In the last ten years, the norm has been two sellers for every buyer. Currently, it is the opposite, and there are now two insiders buying for every seller. Insiders have historically had a good track record and their outlook is obviously very different than that of other equity investors.

Technology continues to be a significant weight in the portfolio. We expect that employment will remain anemic and that companies will look to improve margins through the increased use of hardware, software and by outsourcing their information technology needs. In addition, technology companies have significant cash on their balance sheets. At the end of the second quarter, the cash level for U.S. technology companies reached \$374 billion, an all-time high. In the S&P 500, technology has 80% more cash than any other sector, and represents 32% of total corporate cash. We expect that companies will engage in more mergers and acquisitions and stock buybacks.

We continue to believe U.S. equities are undervalued, debt is cheap and so there will be continued share buybacks, dividend increases, and acquisitions. In the third quarter, Netlogic Microsystems was acquired for a 65% premium. Early in the fourth quarter, Complete Production Services was acquired for a 50% premium.

We thank you for your continued support.

Kind regards,

A handwritten signature in cursive script, appearing to read "Bill".

William D. Jones